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Distributions from Value-Added Cooperatives

Neil E. Harl
Iowa State University

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Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.

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Issue Contents

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DISTRIBUTIONS FROM VALUE-ADDED COOPERATIVES

— by Neil E. Harl*

The handling of distributions from cooperatives[1] and corporations[2] is relatively clear-cut and certain, although occasionally problems arise.[3] But distributions from value-added cooperatives are a somewhat different matter where a farmer typically plays a dual role as investor and as a supplier of needed raw materials. A 2002 Tax Court case has cast additional light on one aspect of that area of increasing importance to farm taxpayers, liability for self-employment tax on distributions.[4]

General Rule

The general rule on liability for self-employment tax is well-known.[5] Self-employment tax is imposed on net earnings from self-employment, defined as net earnings from a trade or business carried on by the taxpayer.[6] Rentals from real estate are excluded but rentals involving the production of agricultural or horticultural commodities are subject to SE tax if the taxpayer materially participates in the production or management of production under the lease.[7] The imputation of activities of an agent to a property owner as principal is specifically barred by a 1974 amendment.[8]

The 1998 Case

In a 1998 small claims Tax Court decision,[9] a Minnesota farmer, while actively farming, had become a member of a value-added cooperative. Membership in the cooperative required delivery of corn by the taxpayer to the cooperative. During that period, distributions from the cooperative were apparently reported as net earnings from self-employment.[10]

After the taxpayer retired, the taxpayer no longer produced corn to meet the obligation. However, the governing documents of the cooperative allowed a member to fulfill the obligation to deliver corn by paying a small fee and drawing from a pool maintained for members of the cooperative whose production fell below their commitment to deliver.[11] The taxpayer, in keeping with the reduced level of involvement in the farming operation in retirement, took the position that the distributions from the cooperative were investment income and not subject to the 15.3 percent self-employment tax.[12] IRS disagreed, believing that the taxpayer was engaged in a trade or business of processing and concluding, therefore, that the distributions were self-employment income.[13]

The Tax Court, in a small claims decision, agreed with the taxpayer and held that the taxpayer was not subject to SE tax on payments from the value-added cooperative. About a year later, the Chief Counsel's Office conceded the issue.[14] The notice of concession indicated, however, that if the Form 4835 (or, presumably, any other form

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* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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for reporting rental income) reveals that the taxpayer actively participated in the farming operation, that could indicate a nexus with grain production which could support a conclusion that the farmer was in the trade or business of grain processing.[15]

The language in the Chief Counsel's Notice[16] was especially notable in light of the fact that crop share landlords often claim expense method depreciation[17] in retirement which requires "meaningful participation" for eligibility.[18] While it is not clear whether "meaningful participation" requires less involvement than "active participation," the two concepts are uncomfortably close for a reliable decision-making line to be drawn between the two concepts.

The 2002 Case

In a 2002 decision by the Tax Court,[19] a retired farmer and his wife (who were members of a value-added cooperative which also required the delivery of corn) were operating under a crop-share lease with the sons as tenants. The court held that the retired farm taxpayers had to report the value-added payments from the cooperative as self-employment income.[20] The court, while acknowledging the taxpayers' reliance on the earlier case of *Hansen v. Commissioner*,[21] cautioned that the case cannot be cited as precedent and held that the taxpayers were engaged in the trade or business of producing, marketing and selling corn and corn products in its relationship with the cooperative and thus were liable for the 15.3 percent self-employment tax.[22] The court determined that, inasmuch as the value-added payments were directly related to the volume of corn delivered to the cooperative, the value-added payments had a direct nexus to their trade or business and must be included in self-employment income.

Surprisingly, in *Bot v. Commissioner*,[23] the Tax Court stated that the conclusion was reached in light of the involvement by the taxpayers in the operation (which apparently fell short of material participation) and the involvement of the taxpayers' sons. As stated by the Tax Court¾

> "We are satisfied that the value-added payments were derived from petitioners' trade or business. Petitioners, either directly or through the sons as their agents, regularly acquired and delivered option pool corn to MCP [the value-added cooperative] which MCP processed and then marketed and sold for petitioners."[24]

The surprising feature is that, since enactment of a 1974 amendment,[25] imputation of activities by an agent to a principal as property owner under a lease (and involving the production of agricultural or horticultural commodities) has been barred for purposes of self-employment tax liability.[26] In *Bot v. Commissioner*,[27] the only apparent business relationship of the taxpayer and the taxpayer's sons was through the crop-share lease. If the parties' relationship is through the lease, the language of the Tax Court is inconsistent with the statute. The Tax Court does not make it clear whether the agency relationship of the sons with the parents was through the lease or was independent of the lease. That distinction is significant in light of the bar on imputation of activities of an agent to a principal under a lease.[28]

Even without imputation of the sons' activities, the taxpayer might have been subject to 15.3 percent self-employment tax. Involvement may have been sufficient for trade or business status (referred to as "active participation" in the Chief Counsel's Notice)[29] which entails less involvement in the operation than "material participation" which is the test for trade or business status for purposes of liability for self-employment tax under a lease.[30]

Is an LLC the solution?

Some are considering conveying the interest in the value-added cooperative to an LLC to avoid the self-employment tax problem. The difficulty with that is that the regulations addressing the circumstances under which an LLC member (or limited partner in a limited partnership) have SE income are still in a state of limbo. Under regulations proposed in 1997, an individual is considered to be a limited partner for self-employment tax purposes unless the individual has personal liability for the debts or claims of the entity, has authority to contract for or on behalf of the entity, or participates in the entity's trade or business for more than 500 hours during the entity's taxable year.[31] However, the Taxpayer Relief Act of 1997 prohibited the IRS from issuing temporary or final regulations defining a limited partner for self-employment tax purposes before July 1, 1998.[32] Although July 1, 1998, has come and gone, IRS has been unwilling to finalize the regulations.

In conclusion

The case of *Bot v. Commissioner*[33] is unlikely to be the last word on the subject but it is becoming clear that retired members of value-added cooperatives need to watch their involvement under the arrangement with the cooperative if SE tax is to be avoided.

FOOTNOTES

1 See generally 14 Harl, *Agricultural Law* § 135.01 (2001); Harl, *Agricultural Law Manual* § 14.03 (2001).
2 See generally 7 Harl, *Agricultural Law* § 55.04 (2001); Harl, *Agricultural Law Manual* § 7.02[3] (2001).
3 See Harl, "Handling Gains and Losses on Cooperative Stock," 13 *Agric. L. Dig.* 1 (2002).
4 See Bot v. Comm'r, 118 T.C. No. 8 (2002).
5 See generally 5 Harl, *Agricultural Law* § 37.03 (2001); Harl, *Agricultural Law Manual* § 4.06[3] (2001).
6 I.R.C. Sec. 1402(a).
7 I.R.C. Sec. 1402(a)(1).
8 *Id.* See notes 25-26 *infra.*
9 Hansen v. Comm'r, T.C. Summary Op. 1998-91.
10 *Id*.
11 *Id*.
12 *Id*.
13 *Id*.
14 Chief Counsel Notice N(36)000-3, April 21, 1999.
15 *Id*.
16 N(36)000-3, April 21, 1999.
17 I.R.C. § 179.
18 Treas. Reg. § 1.179-2(c)(6)(ii).
19 Bot v. Comm'r, 118 T.C. No. 8 (2002).
20 *Id*.
21 T.C. Summary Op. 1998-91.
22 Bot v. Comm'r, 118 T.C. No. 8 (2002).
23 118 T.C. No. 8 (2002).
24 Bot v. Comm'r, 118 T.C. No. 8 (2002).
25 Pub. L. No. 93-368, § 10(b), 88 Stat. 420 (1974).
26 See I.R.C. Sec. 1402(a)(1).
27 118 T.C. No. 8 (2002).

[28] See note 25-26 *supra*.
[29] N(36)000-3, April 21, 1999.
[30] See I.R.C. § 1402(a), (a)(1).
[31] Prop. Treas. Reg. § 1.1402(a)-2(h).
[32] Pub. L. No. 105-34, Sec. 935, 111 Stat. 882 (1997).
[33] 118 T.C. No. 8 (2002).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAX-*ALM* § 13.03[7].*

DISCHARGE. The debtor had served as executor to a decedent's estate which had failed to fully pay federal estate taxes due to the acts and omissions of the debtor. The IRS sought to have the estate taxes declared nondischargeable under Section 523(a)(4) as resulting from defalcation by the debtor committed while serving as a fiduciary. The debtor argued that the Section 523(a)(4) exception to discharge did not apply because the debtor owed no fiduciary duty to the IRS. The court held that, under Tex. Probate Code § 37, an executor owes a fiduciary duty to an estate's creditors, including the IRS; therefore, the estate taxes owed as a result of the debtor's actions as executor were nondischargeable. ***In re* Tomlin, 266 B.R. 350 (N.D. Tex. 2001)**.

The taxpayer plead guilty to conspiracy to evade taxes by transferring income to an overseas corporation. After the conviction and amendment of the tax returns, the debtor continued to attempt to evade payment of the taxes involved by transferring assets to family members and using the proceeds of asset sales to make speculative investments which failed. The court held that the plea of guilty to conspiracy to evade taxes and the failure to pay the taxes while having sufficient assets to pay the taxes was sufficient to make the taxes nondischargeable for willful attempt to evade taxes under Section 523(1)(1)(C). ***In re* Summers, 266 B.R. 292 (Bankr. E.D. Pa. 2001)**.

ESTATE PROPERTY. The debtors received a payment from the IRS as part of the EGTRRA 2001 advance refund checks mailed to taxpayers resulting from the retroactive reduction of the lowest tax bracket to 10 percent. The debtors filed their Chapter 7 petition in February 2001. The court ruled that the payment represented a refund of 2001 taxes taxes. If the funds are less than or equal to the tax liability, it would be characterized as a refund and a pro rata share would go to the bankruptcy estate. If the debtors' 2001 tax is less than the post-petition refund amount, all of the refund check is to be returned to the debtors. ***In re* Lambert, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,317 (Bankr. D. Or. 2002)**.

PREFERENTIAL TRANSFERS. The Chapter 7 debtor owed delinquent child support payments and had filed for a refund on the debtor's income tax. The IRS withheld the refund and paid it to the county Child Support Enforcement Agency which paid the amount to the debtor's former spouse. The Chapter 7 trustee sought recovery of the refund as a preferential transfer. The IRS argued that the refund was exempt from preferential transfer status under Section 547(c)(7) as a child support payment. The trustee argued that the exception in Section 547(c)(7)(A) applied because the child support payment was essentially assigned to the county agency. The court held that, under Ohio law, the child support agency functioned only as a trustee for the former spouse and children in collecting and distributing child support payments; therefore, no assignment occurred and the payment of refund to the agency was not a preferential transfer. ***In re* Sanks, 265 B.R. 566 (Bankr. N.D. Ohio 2001)**.

CONTRACTS

BREACH. The defendants entered into a lease/purchase agreement to acquire a ranch owned by the plaintiffs. The contract included the leasing of cattle owned by the plaintiffs. A dispute arose from a claim by the defendants that there was insufficient hay on the property to feed the cattle through the winter. The plaintiff filed suit to recover unpaid rent and for specific performance of the purchase contract. The defendants counterclaimed for the cost of replacement feed and for damages caused by misrepresentations by the plaintiffs and their real estate agent as to the quantity and quality of the property. The court held that the claim for misrepresentation was properly dismissed by the trial court because the defendants had made an inspection of the property and failed to object to any of the inconsistencies between the plaintiffs' description of the property and the actual condition of the property. The court held that the defendants did not reasonably rely on the representations of the plaintiffs and their agent. Other claims were held not to be false, either because of the evidence presented by the plaintiffs or the failure of the defendants to prove the claims false. The jury had found that the lease/purchase contract was only a lease; therefore, the plaintiffs suit for specific performance was denied. The court noted that the parties disagreed on several aspects of the purchase terms of the contract; therefore, specific performance was not appropriate since the court could not determine the extent of the performance required by the contract. **Dewey v. Wentland, 38 P.3d 402 (Wyo. 2002)**.

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC and the FSA have adopted as final regulations providing procedures for federal crop insurance program participant appeals of adverse decisions